Overview

Texas Tax Code Chapter 171

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Franchise Tax – Comparison

Old Law

Effective for reports originally due on or before 12/31/2007

DESCRIPTION:

The Texas franchise tax is a privilege tax.

TAXABLE ENTITIES:

Corporations

Limited Liability Companies

DUE DATE:

Initial Reports: one year and 89 days after beginning date.

Annual Reports: May 15

ACCOUNTING PERIOD:

Annual Report – Accounting year ending in calendar year prior to report year.

RATE:

0 .25% (.0025) per year of privilege period of net taxable capital, or

4.5% (.0450) of net taxable earned surplus.

TAX BASE:

Taxable Capital and Earned Surplus

Revised Law

Generally, effective for reports originally due on or after 01/01/2008

DESCRIPTION:

The Texas franchise tax is a privilege tax.

TAXABLE ENTITIES:

Corporations

Limited Liability Companies

Partnerships (with exceptions)

Professional Associations

Joint Ventures

Business Trusts

Other legal entities

No Change

DUE DATE:

No Change

ACCOUNTING PERIOD:

RATE:

1.0% (.01) for most

0.5%(.005) for entities primarily engaged in retail or wholesale trades

OR

E-Z rate of 0.575% (.00575)

TAX BASE:

Margin

Taxable vs. Nontaxable Entities
Rule 3.581

Taxable Entities
(domestic & foreign)

Corporations

Limited Liability Companies

Partnerships (general, limited & limited liability)

Business Trusts

Professional Associations

Business Associations

Joint Ventures

Other legal entities

Non Taxable Entities
(domestic & foreign)

Sole Proprietorships (does not include single member limited liability companies)

General Partnerships (directly and wholly owned by natural persons and not a limited liability partnership)

Passive Entities (as defined under Texas Law)

Estates

Escrow

Natural Person is "a human being as distinguished from a purely legal entity given recognition as the possessor of rights, privileges, and responsibilities, such as a corporation, limited liability company, partnership, or trust."

Passive Entities
§171.0003 / Rule 3.582

- Must be a general, limited, or limited liability partnership or a trust (not a business trust).
- Must notify the Comptroller that the entity qualifies as passive.
- Determination of passive is based on the activity in the applicable accounting period; 90% of the entity's federal gross income must be from passive activities as described in §171.0003:
  - Dividends
  - Interest
  - Distributive share of partnership income
  - Net capital gains from sale of real property, commodities (sold on an exchange), and securities
  - Royalties, bonuses, delay rental income from mineral properties
- Rent is not considered passive income.

Qualification for 0.5% Tax Rate

(used to determine applicable tax rate – Rule 3.584(d)(2))

- Retail Trade:
  means the activities described in Division G of the 1987 Standard Industrial Classification Manual published by the federal office of Management and Budget.

- Wholesale Trade:
  means the activities described in Division F of the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget.

http://www.osha.gov/pls/imis/sicsearch.html

Taxable Entities primarily engaged in retail or wholesale trades will qualify to use the 0.5% tax rate.

A taxable entity is primarily engaged in retail or wholesale trade only if:

(1) the total revenue from its activities in retail or wholesale trade is greater than the total revenue from its activities in trades other than the retail and wholesale trades;

(2) less than 50 percent of the total revenue from activities in retail or wholesale trade comes from the sale of products it produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs (this does not apply to Eating & Drinking Places described in Major Group 58 of Division G); and

(3) the taxable entity does not provide retail or wholesale utilities, including telecommunications services, electricity or gas.

The Revised Tax Base
“Margin”

Margin is computed in one of three ways:

1) Total Revenue times 70%

2) Total Revenue minus Cost of Goods Sold

3) Total Revenue minus Compensation

Taxable Margin will be the lowest of the three computations times the apportionment factor.

No Tax Due

Based on calculation formulas and discounts, the following entities will not owe any tax:

- entities with total revenue of $434,782* or less
- entities that calculate they owe less than $1,000

All taxable entities will be required to file a report as they do under current law.

§171.0002 actually says $300,000, however the highest revenue amount that will always result in no tax due is $434,782.

Discounts

from tax liability for small businesses
Section 171.0021 / Rule 3.584(d)(4)

The discount rates, based on total revenue, are:

> $300,000, but < $400,000 = 80% of tax due

≥ $400,000, but < $500,000 = 60% of tax due

≥ $500,000, but < $700,000 = 40% of tax due

≥ $700,000, but < $900,000 = 20% of tax due

E-Z Computation
§171.1016 / Rule 3.584(d)(5)

An alternative to computing margin for taxpayers whose total revenue is $10 million or less.

(E-Z filers qualify for tax discounts, but no other credits)

Total Revenue

X Apportionment Factor

Apportioned Revenue

X 0.00575 (0.575% rate)

Tax Due before discounts

Annalized Revenue

Total Revenue must be annualized to determine eligibility for $300,000 No Tax Due threshold, Discounts, and E-Z Computation.

<u>Formula:</u>
(Total Revenue / # days in period upon which the tax is based) x 365 (366 in leap years) = Annualized Revenue

Examples:

1. A taxable entity's 2008 franchise tax report is based on the period 09/15/2007 through 12/31/2007 (108 days) and its total revenue for the period is $50,000. The taxable entity's annualized revenue is $168,981 ($50,000 divided by 108 days times 365 days).
2. A taxable entity's 2008 franchise tax report is based on the period 01/01/2006 through 12/31/2007 (730 days) and its total revenue for the period is $1,500,000. The taxable entity's annualized revenue is $750,000 ($1,500,000 divided by 730 days times 365 days).

Example:

70% of Revenue Calculation		E-Z Computation
$899,000	total revenue	$899,000
X .7	% margin	$629,300
	margin	
x 1.0	apportionment factor	X 1.0
$629,300	taxable margin/apportioned revenue	$899,000
X .01	tax rate	X .00575 (.575%)
$6,293.00	tax due before discount	$5,169.25
X .20	discount rate	X .20
$1,258.60	discount allowed	$1,033.85
$5,034.40	net tax due	$4,135.40

Total Revenue
§171.1011 / Rule 3.587

Begin with amounts reported on specified lines of federal income tax reports – to the extent that amounts reported comply with federal tax law.

- For a corporation, total revenue is the sum of:
  - Form 1120, line 1c plus lines 4 through 10
- For a partnership, total revenue is the sum of:
  - Form 1065, line 1c plus lines 4, 6 and 7
  - Form 1065, Schedule K, line 3a plus lines 5-11
  - Form 8825, line 17
  - Form 1040, Schedule F, line 11 plus line 2 OR line 45

(Line items refer to items on 2006 IRS forms)

Exclusions from Revenue

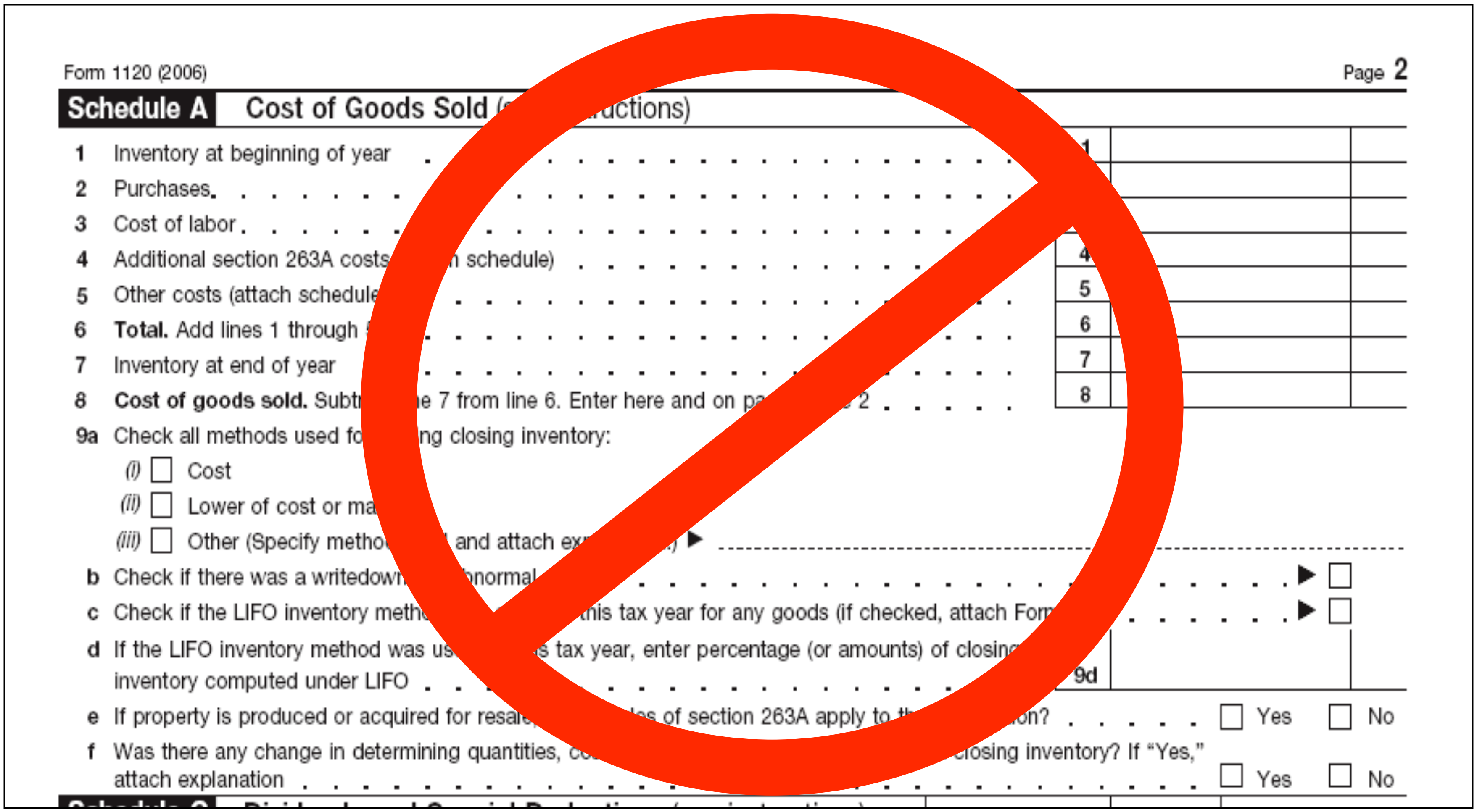
(list is not all inclusive)

To the extent included in total revenue:

- schedule C dividends;
- foreign royalties and foreign dividends including amounts under Section 78 and Sections 951-964;
- net distributive income from taxable entities treated as a partnership or as an S corporation for federal income tax purposes and items of income attributable to a disregarded entity;
- certain flow-through funds;
- revenue from Medicaid, Medicare, Children's Health Insurance Program (CHIP), workers' compensation claims, TRICARE, and actual costs for uncompensated care (100% for health care providers, 50% for health care institutions);
- dividends and interest from federal obligations.

Cost of Goods Sold
§171.1012 / Rule 3.588

COGS for federal tax does not equal COGS for franchise tax.



Cost of Goods Sold §171.1012 / Rule 3.588

Goods means real or tangible personal property sold in the ordinary course of business – it does not include services.

Includes direct costs of acquiring or producing goods:

- Production labor (including contract labor reported on form 1099)
- Materials
- Inbound transportation
- Storage
- Rental/leasing/repair/maintenance of equipment or facility used in production
- Research & development
- Quality control
- Utilities used directly in production

Includes costs related to the production or acquisition of goods:

- Deterioration
- Obsolescence
- Spoilage & abandonment
- Preproduction direct costs
- Postproduction direct costs
- Insurance on facilities & equipment used in production of goods
- Insurance on produced goods
- Licensing or franchise costs

Plus indirect or administrative overhead costs allocable to the acquisition or production of goods, limited to 4% of total indirect or administrative overhead costs.

Cost of Goods Sold §171.1012 / Rule 3.588

Cost of goods sold specifically excludes:

- Cost of renting or leasing equipment, facilities, or real property that is not used for the production of goods
- Officer's compensation
- Selling costs – including employee expenses related to sales
- Advertising costs
- Distribution costs – including outbound transportation
- Compensation paid to an undocumented worker

Allowable costs may be:

- expensed for the period upon which the report is based; or
- capitalized in the same manner and to the same extent capitalized on the federal income tax return if the entity is subject to IRC Sec. 263A, 460, or 471.

Compensation §171.1013 / Rule 3.589

Includes:

- Wages and cash compensation (not to exceed $300,000 per officer, director, owner, partner, or employee):
  - ⇨ W-2 wages, and
  - ⇨ to the extent not included on the W-2, net distributive income from partnerships, limited liability companies and S corporations, if paid to a natural person, and stock awards and stock options.
- Benefits, to the extent deductible for federal income tax purposes, including workers' compensation, health care, employer contributions to health savings accounts and retirement.

Does Not Include:

- Wages and cash compensation paid to undocumented workers
- Employer's share of payroll taxes
- Contract wages reported on form 1099

Gross Receipts & Apportionment

Apportionment factor equals
Texas gross receipts / everywhere gross receipts.

Gross receipts everywhere will almost always equal total revenue.*

Apportionment is generally the same as current law, although throwback provisions have been repealed.

Sections 171.101(a)(1), 171.103, 171.105, and 171.1055. Rule 3.591.

* Total revenue will not always equal gross receipts everywhere for health care providers, health care institutions, lawyers, and security broker/dealers.

Combined Reporting
§171.1014 / Rule 3.590

Mandatory for affiliated groups:

1) in which more than a 50% interest is owned by a common owner, and
2) members of group are engaged in a unitary business.

Unitary Business means:

a single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.

For Texas franchise tax reporting, members of an affiliated group are presumed to be engaged in a unitary business.

Combined Reporting
§171.1014 / Rule 3.590

Combined groups include all entities, even those without nexus, that meet the two criteria – ownership & unitary.

Factors to be Considered in Determining a Unitary Business

Are the activities of the members:

- in the same general line of business, or
- steps in a vertically structured enterprise or process, or
- functionally integrated through the exercise of strong centralized management.

Reporting Entity

The combined group's choice of an entity that is:

- the parent entity, if it is part of the unitary business; or
- an entity that is part of the combined group; is subject to Texas' taxing jurisdiction; and has the greatest Texas business activity during the first year that a combined report is required to be filed.

Gross Receipts & Apportionment

- Texas gross receipts do not include receipts from members without nexus.
- Everywhere gross receipts include receipts from all members of the group.

Credits
Rules 3.593 and 3.594

Installments and Carryovers from Economic Development Credits can be used

Old Temporary Credit from 1992

New Temporary Credit based on unused Business Loss Carryforwards

Credit for Business Loss Carryforwards

Section 171.111 and Rule 3.594

Provides that an entity, that was subject to the franchise tax on May 1, 2006, is eligible to take a credit based on business loss carryforwards that were not expired or exhausted on a report originally due before January 1, 2008.

A business loss was defined in Section 171.110(e) as “any negative amount of earned surplus after apportionment and allocation.”

The right to take the credit must be preserved on a form provided by the Comptroller on or before the due date of its 2008 franchise tax report.

Eligible entities may take the credit on franchise tax reports originally due on or after January 1, 2008 – most credits will be taken for the first time on the annual report due on May 15, 2008.

Credit calculation is as follows:

Report years 2008 – 2017: business loss carryforwards x 2.25% x 4.5%

Report years 2018 – 2027: business loss carryforwards x 7.75% x 4.5%

Extensions
§ 171.202

Report Year 2008

- Newly taxable entity – may extend but must pay 90% of amount that will be due on the extended due date.
- Combined groups – if all members previously filed franchise tax reports, then the 100% option is available.
- If the group includes an entity that was not required to file a 2007 franchise tax report, then the 100% option is not available.

Franchise Tax Reporting

Preprinted report forms will no longer be mailed to taxpayers. Instead they will receive a return generation letter with tax ID and password (XT number).

Three options for filing reports:

1) **Webfile.pdf submit**: File a report and pay electronically (currently available for No Tax Due and Extensions).
2) **Smart.pdf** - Complete a report or extension request online, print and mail with payment.
3) **Plain.pdf** - Print a report or extension request, complete manually and mail with payment.

Franchise Tax Reporting

<u>No Tax Due</u>

05-163 No Tax Due Information Report
05-102 Public Information Report
05-167 Ownership Information Report
05-175 Tiered Partnership Report

<u>EZ Computation</u>

05-169 EZ Computation Report
05-102 Public Information Report
05-167 Ownership Information Report
05-170 Payment Form
05-166 Affiliate Schedule
05-175 Tiered Partnership Report

<u>Long Form</u>

05-158-A Franchise Tax Report Page 1
05-158-B Franchise Tax Report Page 2
05-160 Credits Summary Schedule
05-102 Public Information Report
05-167 Ownership Information Report
05-170 Payment Form
05-166 Affiliate schedule
05-175 Tiered Partnership Report

<u>Extension</u>

05-164 Extension Request
05-165 Extension Affiliate List

Franchise Tax Rules

3.581 Margin: Taxable and Nontaxable Entities
3.582 Margin: Passive Entities
3.583 Margin: Exemptions
3.584 Margin: Reports and Payments
3.585 Margin: Annual Report Extensions
3.586 Margin: Nexus
3.587 Margin: Total Revenue
3.588 Margin: Cost of Goods Sold
3.589 Margin: Compensation
3.590 Margin: Combined Reporting
3.591 Margin: Apportionment
3.592 Margin: Additional Tax
3.593 Margin: Franchise Tax Credit
3.594 Margin: Temporary Credit for Business Loss Carryforwards
3.595 Margin: Transition

Case Study
Reporting Requirements

Facts:

- Corporation A is a separate entity from 1/1/07 through 6/30/07.
- On July 1, 2007 Corp A was acquired by Corp X combined group and is owned by them until 9/30/07. X has a 3/31/07 accounting year end.
- On October 1, 2007 A is sold by X to Z.
- Group Z has a 12/31 AYE.
- Corp A had $250,000 in total revenue for the period of 1/1/07 – 6/30/07.

Response:

- All entities/groups will file 2008 annual reports.
- Corp A will file on its own for the period 1/1/07 through 6/30/07. It does not qualify for a No Tax Due report based on total revenue. It's annualized Total Revenue is $500,000 which is greater than the $300,000 threshold.
- Corp X group will file a combined report on May 15, 2008 based on the period 4/1/06 through 3/31/07. It will NOT include Corp A in the 2008 report because A was not part of the group during the period upon which the tax is based. It will include Corp A in its 2009 annual report for the period 7/1/07 through 9/30/07.
- Corp Z group will file a combined report on May 15, 2008 based on the period 01/01/07 through 12/31/07 and will include Corp A's data for the period 10/01/07 through 12/31/07.

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